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An unending variety of topics

Monday, June 05, 2006

Property, security, and freedom

I have written about how historical forms of political and legal structures have depended on needs to secure property. Recently scholars and writers ranging from Michael L. Ross to Thomas Friedman have pointed out how oil revenue tends to vary inversely with democracy and freedom. Their main theory for this is that oil revenues allow governments to boost their own power and protect themselves from irate citizens. This is particuarly the case when oil prices are high, as now, whereas lower oil prices tend to decrease government power and encourage freedom. Taxing citizens or their more diffuse property directly tends to encourage democracy movements, but pricy oil allows despotisms in today's Venezuala, Russia, Saudi Arabia, Iran, and elsewhere to avoid depending overly on such diffuse taxes for their power. (Historically, democracy tended to emerge, for example in England, by the need for kings to get the "consent" of the realm via Parliament to tax internal property).

What these scholars tend not to have focused on, however, is why governments derive so much revenue and power from oil as opposed to manufactured goods, information, or services. The answer lies in the legal uncertanties and the physical insecurity of investments in oil relative to other kinds of taxable property. Private property rights in oil have tended to be problematic, because of the novelty of the industry, because these legal structures were created during an era (early 20th century) when private property was unpopular in most legal circles, and because of the large ratio of initial capital investment to subsequent operating costs needed to extract the oil.

All mineral rights give rise to legal problems, due to the interferences (externalities) that occur between mineral rights and rights in the overlying land. Mineral investments tend to be insecure because of the large ratio of initial capital investment in discovery and development to subsequent operating costs. In other words, once the exploration companies do the hard work, it is easy for whoever has the political or military power to come along and steal the benefits. This ratio is far larger for oil in particular than for the farmland which we have seen historically was very dependent on large scale militiaries for protection, and it is high for minerals generally. Once most kinds of minerals, and especially oil, are found, they are far more vulnerable than other kinds of property to political appropriation. Legal uncertainties and the nationalist and socialist traditions surrounding oil encourage this in particular for oil. As a result, most oil deposits around the globe have been nationalized, and even where they have not been nationalized their extraction is usually subject to steep taxation. Michael L. Ross has shown that the inverse relationship between oil and indicia of freedom is "valid and statistically robust" and extends to states rich in other kinds of minerals, which share the large ratio of initial capital investment in discovery and development to subsequent operating costs. The security needs of oil and other mineral property, combined with the unwillingess of governments providing that security to forego the revenue windfall (for example by privatizing oil fields *and* not steeply taxing them), explains why this is so.

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Nick Szabo

"A premier thinker about history, law and economics, and the lessons they have for security." -- Adam Shostack, Emergent Chaos

"Szabo comes out with these essays that leave me in awe." -- Brian Dunbar

"Reading material that is eclectic, challenging and endlessly fascinating." -- Sean McGrath, Propylon

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Posted by Nick Szabo at 12:16 PM

2 comments:

alec said...

I agree that this is a valid relationship for undeveloped countries (though I would say that Norway, the US, and even Mexico are in market systems with democracies while having an abundance of petrolum). I actually about this a few times, specifically in relation to Russia and the ability to lean on other countries through economic clout & energy. Good post though!

3:57 PM

Nick Szabo said...

Much of this is political inertia. We are still largely dominated by political ideas developed when agriculture was the dominant form of property. When a country industrializes first (more goods-dominated) you get more republican institutions, which borrow heavily from the medieval city republics (also goods dominated). When it goes straight from agriculture to oil, like Saudi Arabia or Venezuala, you don't have much chance for republican institutions to develop.

11:38 PM

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